

THE EFFECT OF BANKRUPTCY ON INTELLECTUAL PROPERTY RIGHTS

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I. INTRODUCTION

In an economy in which patented technology, copyrighted media and software content, and product differentiation based on trademarked brand names play a major role, rights to intellectual property such as copyrights, patents, and trademarks may be of critical importance to a business enterprise. Such rights often depend on contractual licenses, which may be negatively affected by a bankruptcy filing by one of the parties to the contract. This outline explores the effect of a bankruptcy filing on the nondebtor's rights under an intellectual property license both where the debtor is the licensor, and where the debtor is the licensee.

In addition, where a lender extends secured credit to an enterprise whose value is derived in large measure from intellectual property rights, such rights may comprise a substantial portion of the value of the lender's collateral, either directly (as where the lender takes a security interest in intellectual property rights), or indirectly (as where the collateral includes inventory whose value depends on intellectual property rights, such as trademarks or copyrightable labeling, which differentiate it from similar products produced by others). This outline also explores the effect of a bankruptcy filing on security interests that implicate intellectual property rights.

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II. THE EFFECT OF BANKRUPTCY ON INTELLECTUAL PROPERTY LICENSES

A. The Effect Of Bankruptcy Where The Debtor Is The Licensor.

1. In General.

Section 365 of the Bankruptcy Code generally provides that, subject to certain limitations and qualifications, a trustee (or chapter 11 debtor in possession), "may assume or reject any executory contract or unexpired lease of the debtor." 11 U.S.C. § 365(a). Where a party has licensed intellectual property from a licensor who subsequently becomes a debtor in a bankruptcy case, this language creates two immediate questions: (a) is an intellectual property license an "executory contract"; and (b) what is the effect of the "rejection" of the contract by the debtor?

With respect to the first issue, exclusive intellectual property licenses are generally treated as executory contracts under the Bankruptcy Code, because the licensor has a continuing obligation to refrain from licensing the intellectual property to third parties, and the licensee has a continuing obligation to pay royalties, account to the licensor, etc. See Encino Bus. Management, Inc. v. Prize Frize, Inc. (In re Prize Frize, Inc.), 32 F.3d 426, 428 (9th Cir. 1994); In re Select-A-Seat Corp., 625 F.2d 290 (9th Cir. 1980). (Note, however, that in Select-A-Seat, the debtor in possession rejected only the exclusivity obligation, and not the license itself).

It could be argued that a nonexclusive license is not an executory contract, because the grant of a license can be analogized to the executed conveyance of a property right; and a nonexclusive license does not impose on the licensor the executory obligation not to license others. If the nonexclusive license is viewed in this fashion, then it is arguable that "rejection" would terminate only any ongoing obligations of the debtor/licensor under its covenants and warranties, and would leave the licensee's enjoyment of the previously granted license rights unaffected. This has not, however, been a winning argument. In Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.), 756 F.2d 1043 (4th Cir. 1985), cert. denied, 475 U.S. 1057 (1986), the court held that a nonexclusive technology license was an executory contract whose rejection by the debtor terminated the licensee's rights to use the licensed technology.

In response to decisions such as Lubrizol Enters., Congress enacted section 365(n) of the Bankruptcy Code, "to make clear that the rights of an intellectual property licensee to use the licensed property cannot be unilaterally cut off as a result of the rejection of the license pursuant to section 365 in the event of the licensor's bankruptcy." S. Rep. No. 505, 100th Cong., 2d Sess. 1 (1988). In essence, section 365(n) provides that if a trustee or debtor in possession rejects "an executory contract under which the debtor is a licensor of a right to intellectual property," the licensee under the contract may elect to retain its rights to the use of the intellectual property (including exclusivity provisions) as such rights existed immediately before the commencement of the bankruptcy case, for the duration of the contract. 11 U.S.C. § 365(n)(1)(B). After such election, the debtor in possession or trustee must allow the licensee to exercise its rights, and the licensee must continue to make all royalty payments due under the contract for the duration of the contract. Any claim by the licensee for damages for breach of the contract is treated as a nonpriority general unsecured claim. See 11 U.S.C. § 365(n)(2).

As noted below, section 365(n) is not a panacea; it has several limitations that must be considered when dealing with agreements involving the use of intellectual property.

2. Limitations On The Protection Of Bankruptcy Code Section 365(n).

a. Exclusion Of Trademark Licenses.

Section 365(n) applies only to contracts under which the debtor is a licensor of "intellectual property," which is a defined term under section 101(35)(A) of the Bankruptcy Code. Although copyrighted materials (works of authorship protected under title 17 of the United States Code) and patents are included in the definition of "intellectual property," trademarks are not included and presumably are not protected. See 11 U.S.C. § 101 (35A). This exclusion may jeopardize the rights of a nondebtor licensee who takes a license of a trademark and of copyrighted material to which the trademark is integrally related. The debtor may argue that the license of the trademark and of the copyrighted material are inseparable; that the copyrighted material cannot be used without the trademark; and, therefore, that if the rejection of a trademark license is

effective to prevent the nondebtor licensee from continuing to use the trademark, the nondebtor licensee should no longer be able to use the related copyrighted material. In In re Matusalem, 158 B.R. 514 (Bankr. S.D. Fla. 1993), however, the court concluded that where a trademark is integrally linked to other intellectual property, section 365(n) is controlling.

In Matusalem, the debtor licensor sought to reject a sub-franchise agreement which afforded the nondebtor licensee exclusive rights to the debtor's secret formula used to make rum products, exclusive rights to manufacture and sell these products within the nondebtor's territorial area, and exclusive rights to use the debtor's trademarked rum label. The court held that the debtor could not reject the agreement as rejection did not satisfy the business judgment test. Id. at 522. More importantly, the court noted that even if rejection were permitted, rejection under section 365(n) would not deprive the nondebtor licensee of any of its rights under the franchise agreement. Id. These rights presumably included the nondebtor licensee's right to the continued use of the debtor's trademark.

b. Need For A "License."

Section 365(n) does not apply to all contracts which somehow involve "intellectual property"; the contract must be one under which the debtor is a "licensor of a right to intellectual property."

c. Licensee's Obligation To Pay Royalties Without Offset.

If the licensee elects to retain its rights to the license under the rejected contract, the licensee must "make all royalty payments due under such contract for the duration of such contract" and is deemed to waive "any right of setoff it may have with respect to such contract under this title or applicable nonbankruptcy law;" 11 U.S.C. § 365(n)(2)(B)-(C). Thus, if the licensee made substantial advances to the debtor under the contract (for example, as an advance against royalties), the licensee would be required to make all royalty payments due under the contract, and would be deemed to waive any right to "setoff" the prepetition advances against those royalty payments. This limitation may not, however, prevent the licensee from exercising a right of "recoupment," as distinguished from a right of setoff. See SAIF Corp. v. Harmon

(In re Harmon), 188 B.R. 421 (B.A.P. 9th Cir. 1995); Photo Mechanical Serv., Inc. v. E.I. Dupont De Nemours & Co. (In re Photo Mechanical Serv., Inc.), 179 B.R. 604 (Bankr. D. Minn. 1995).¹

d. What Is A "Royalty"?

Note that the only payments which section 365(n) requires the licensee to make under the rejected contract are "royalty payments." Thus, the licensee may argue that various payments due under the contract are not "royalty payments" whose payment is required by section 365(n). Such an attempt was made unsuccessfully in Encino Bus. Management, Inc. v. Prize Frize, Inc. (In re Prize Frize, Inc.), 32 F.3d 426 (9th Cir. 1994). The agreement in Prize Frize required the licensee to make payments that were denominated as "royalty payments" and were based on a percentage of certain revenues received by the licensee, and also provided for a "license fee" in a fixed amount to be paid over a specified period. Rejecting the licensee's argument that only the percentage payments that were characterized as "royalty payments" under the contract should be treated as such for purposes of section 365(n), the court held that the term "royalty payments" should be defined broadly to include any payment due for the use of the intellectual property, regardless of the nomenclature used to characterize the payment. See Prize Frize, 32 F.3d at 428-29.

e. Limitation To Existing Intellectual Property.

A license agreement may cover not only existing intellectual property of the licensor, but also intellectual property that the licensor creates in the future as it is created. Section 365(n) does not appear to protect the licensee's right to intellectual property created after the bankruptcy filing; rather, by its terms, section 365(n) protects a licensee's rights to intellectual property "as such rights existed immediately before the

¹ "Although the terms have come to be used interchangeably, there are distinctions which remain relevant in bankruptcy. Setoff allows adjustments of mutual debts arising out of separate transactions between the parties. Recoupment on the other hand, involves the netting out of debt arising from a single transaction. To invoke setoff, section 553 of the Code requires that each of the mutual debts arise before the commencement of the case. In recoupment, the elements of the debt may arise either before or after the commencement of the case." In re Harmon, 188 B.R. at 425.

case commenced " 11 U.S.C. § 365(n)(1)(B) (emphasis added). See Biosafe Int'l, Inc. v. Controlled Shredders, Inc. (In re Szombathy), 1996 WL 417121 (Bankr. N.D. Ill. 1996) (licensee not entitled to any modifications or improvements in debtor's patented tire shredders created after date of debtor's bankruptcy petition). This limitation may create serious problems for the licensee when dealing with intellectual property that is in the process of creation when a bankruptcy proceeding is filed, such as a partially completed record, book, or motion picture. This limitation may also be significant in dealing with property, such as copyrighted computer software, that may be upgraded after the date of filing of the debtor's bankruptcy petition. The licensee's ability to retain a software license may be a hollow victory if the software is rendered obsolete by postpetition upgrades to which section 365(n) protection does not extend.

3. The Nondebtor Licensee's Failure To Record Rights Under An Intellectual Property License May Obviate The Benefits of Section 365(n).

Despite the protection afforded to intellectual property licensees under section 365(n), the licensor's bankruptcy filing may adversely affect the rights of the nondebtor exclusive licensee if applicable nonbankruptcy law requires the recordation of an exclusive license, and the license is not recorded properly. Section 544 of the Bankruptcy Code, 11 U.S.C. § 544, generally permits a trustee (or debtor in possession) to avoid a transfer that is voidable by a hypothetical judicial lien creditor or actual unsecured creditor of the debtor. This provision often is invoked to enable trustees and debtors in possession to avoid unperfected security interests. However, section 544 also empowers a trustee to avoid other transfers that must be recorded under applicable nonbankruptcy law in order to be valid as against a judicial lien creditor, and have not been so recorded before the filing of the debtor's bankruptcy petition.

A trustee's avoiding powers under section 544 may vitiate the protection that the nondebtor party to a rejected executory contract may otherwise be accorded under section 365. For example, section 365(h)-(i) of the Code generally permits the nondebtor lessee under an unexpired lease of real property of the debtor, or the nondebtor vendee under an executory contract of the debtor for the sale of real property or a time share interest under a time share plan, under which the nondebtor lessee or purchaser is in possession, to maintain various rights to the real property,

notwithstanding the nondebtor's rejection of the underlying contract. Nevertheless, the trustee may avoid the lessee's or vendee's rights under section 544 of the Code, if the nondebtor party fails to record the transfer in the manner required by applicable state law. See Webber Lumber & Supply Co. v. Trucklease Corp. (In re Webber Lumber & Supply Co.), 134 B.R. 76 (Bankr. D. Mass. 1991) (debtor in possession, as lessor of real property, could avoid unrecorded lease and purchase option contained therein, even though lessee was in possession); Seidle v. Aeroservice Int'l, Inc. (In re Belize Airways, Ltd.), 12 B.R. 387 (Bankr. S.D. Fla. 1981).

a. Copyright Licenses.

Similarly, and wholly apart from rejection under section 365, the bankruptcy filing of a licensor of copyrighted material may eliminate the rights of the nondebtor holder of an exclusive license if the license is not recorded properly. Under the Copyright Act, a "transfer of copyright ownership" is defined to include "an assignment, mortgage, exclusive license, or any other conveyance, alienation or hypothecation of a copyright or of any of the exclusive rights comprised in a copyright," but does not include a nonexclusive license. 17 U.S.C. § 101 (emphasis added). With respect to the issue of priority between conflicting "transfers of copyright ownership," 17 U.S.C. § 205(d) provides that:

Priority Between Conflicting Transfers. As between two conflicting transfers, the one executed first prevails if it is recorded, in the manner required to give constructive notice under subsection (c), within one month after its execution in the United States . . . , or at any time before recordation in such manner of the later transfer. Otherwise, the later transfer prevails if recorded first in such manner, and if taken in good faith, for valuable consideration or based on a binding promise to pay royalties, and without notice of the earlier transfer.

The issue whether a debtor in possession or trustee in a bankruptcy case could invoke section 205(d) of the Copyright Act to invalidate an unrecorded "transfer of copyright ownership" was addressed in National Peregrine, Inc. v. Capital Federal Savings & Loan Ass'n (In re Peregrine Entertainment, Ltd.), 116 B.R. 194 (C.D. Cal. 1990). There, the District Court held that a security interest in a copyright was not

perfected by filing a financing statement under the Uniform Commercial Code ("U.C.C."), where the security interest had not been filed in the Copyright Office. The Court further held that the status of the debtor in possession (or trustee) as a hypothetical judicial lien creditor under section 544(a)(1) of the Bankruptcy Code enabled the debtor in possession (or trustee) to prevail over the unrecorded security interest, i.e., to avoid the unrecorded "transfer of copyright ownership."

The few subsequently reported cases dealing with the issue have generally followed Peregrine. See Section III.A., infra. Thus, in In re Avalon Software, 209 B.R. 517 (Bankr. D. Ariz. 1997), the court held that the chapter 11 debtor in possession could avoid a security interest in copyrighted and copyrightable computer software and the proceeds thereof where the secured lender failed to record the transfer in the Copyright Office. Inasmuch as the provision of the Copyright Act upon which the courts relied in Peregrine and Avalon Software specifically includes an "exclusive license" within the definition of a "transfer of copyright ownership," failure to record an exclusive copyright license before the date of the debtor's bankruptcy petition should, under the reasoning of these cases, render that license avoidable by a trustee or debtor in possession.

b. Trademarks.

With respect to trademarks, the Lanham Act (title 15 of the United States Code) provides that:

An assignment shall be void as against any subsequent purchaser for a valuable consideration without notice, unless it is recorded in the Patent and Trademark Office within three months after the date thereof or before such subsequent purchase.

15 U.S.C. § 1060 (emphasis added). "Other instruments which may relate to such marks may be recorded in the discretion of the Commissioner." 37 C.F.R. § 2.185.

Although no bankruptcy case has addressed the effect of the failure to record a trademark license in the Patent and Trademark Office, bankruptcy courts have addressed the failure to so record a security interest in a trademark. In Joseph v. 1200 Valencia, Inc. (In re 199Z, Inc.), 137 B.R. 778 (Bankr. C.D. Cal. 1992), the court

addressed whether a trustee in bankruptcy could avoid a security interest in a trademark when the trademark was recorded in the Patent and Trademark Office but was not covered by a filed U.C.C. financing statement. The court held that the Lanham Act provided only for recordation of an assignment of a trademark in the Patent and Trademark Office, and that an assignment is "an absolute transfer of the entire right, title, and interest to the trademark." 199Z, 137 B.R. at 782. In contrast, a security interest is not such a transfer. Id. The court, therefore, held that a security interest in a trademark was not perfected by recordation in the Patent and Trademark Office, but rather by filing a financing statement in compliance with Article 9 of the U.C.C. Id. Subsequent cases have uniformly followed 199Z. See Section III.B, infra.

If a court were to apply the reasoning of 199Z to exclusive trademark licenses, failure to record an exclusive trademark license in the Patent and Trademark Office should not affect its validity as against a trustee or debtor in possession. However, nonbankruptcy courts seem to disagree whether an exclusive license to use a trademark constitutes an "assignment" of the trademark. Compare Quabaug Rubber Co. v. Fabiano Shoe Co., 567 F.2d 154, 159 n.8 (1st Cir. 1977) ("15 U.S.C. § 1127 provides that the term 'registrant' embraces the assignee thereof, and an exclusive licensee is an assignee"); Ste. Pierre Smirnoff, Fls., Inc. v. Hirsch, 109 F. Supp. 10, 12 (S.D. Cal. 1952) (the grant of an exclusive and irrevocable right to use a mark in a designated territory is an assignment and not a mere license). with Estate of Presley v. Russen, 513 F. Supp. 1339, 1350-51 (D.N.J. 1981) (the grant of an exclusive use of a trademark that is limited as to duration or area is not an assignment and will not confer title upon the licensee. "In principle, an assignment is permanent and perpetual, while a license is temporary, provisional or conditional").

Even if an exclusive license is an "assignment" of a trademark for purposes of 15 U.S.C. § 1060, the trustee or debtor in possession could not avoid an unrecorded exclusive license under 11 U.S.C. § 544 of the Bankruptcy Code unless a "purchaser" under section 1060 of the Lanham Act is construed to include a judicial lien creditor. There appears to be no case addressing this issue under the Lanham Act; but bankruptcy court cases involving the recording requirements of the Patent Act (title 35

of the United States Code) suggest that a judicial lien creditor does not fall within the scope of such language. See Section. II.A.3.c, infra.

c. Patents.

With respect to patents, the Patent Act provides that:

Applications for patent, patents, or any interest therein, shall be assignable in law by an instrument in writing. The applicant, patentee, or his assigns or legal representatives may in like manner grant and convey an exclusive right under his application for patent, or patents, to the whole or any specific part of the United States.

* * * *

An assignment, grant, or conveyance shall be void as against any subsequent bona fide purchaser or mortgagee for valuable consideration, without notice, unless it is recorded in the Patent and Trademark Office within three months from its date or before the date of such subsequent purchase or mortgage.

35 U.S.C. § 261. "Other instruments affecting title to a patent ... and licenses ... will be recorded as provided in this section or at the discretion of the Commissioner." 37 C.F.R. § 1.331 (emphasis added).

Although the recording requirements of section 261 of the Patent Act do not appear to cover nonexclusive patent licenses, those requirements do appear to apply to the grant of an exclusive patent license, at least where it is for the life of the patent. Given the specific reference in section 261 of the Patent Act to the ability to "grant and convey" an "exclusive right under a patent application," it appears that the later reference to an "assignment, grant or conveyance" should be construed to encompass the "grant and conveyance" of an exclusive license. Moreover, case law appears to treat an exclusive patent license as an "assignment," at least where the exclusive license is for the life of the patent. See Heywood-Wakefield Co. v. Small, 96 F.2d 496, 499 (1st Cir. 1938) (so-called license contract where patentee granted exclusive right under patent to make, use, and vent invention during term of patent was an assignment); Lamar v. Granger, 99 F. Supp. 17, 36 (W.D. Pa. 1951) (In order to constitute a valid assignment of a patent, owner must transfer all of his rights and

granting anything less is a mere license; however, an exclusive license for the life of the patent is an assignment); American Type Founders v. Dexter Folder Co., 53 F. Supp. 602, 604 (S.D.N.Y. 1943) (An agreement granting an exclusive license for the term of the patent but reserving royalties to the patentee constituted an assignment and not a license).

There appears to be no bankruptcy case addressing the effect of the failure to record a patent license in the Patent and Trademark Office. However, there is case law dealing with the effect of the failure to so record a security interest in a patent, which holds that the failure to record a security interest in a patent with the Patent and Trademark Office does not render the security interest voidable by a trustee or debtor in possession in the position of a hypothetical judicial lien creditor under 11 U.S.C. § 544(a)(1). In In re Transportation Design & Tech., Inc., 48 B.R. 635 (Bankr. S.D. Cal. 1985), the trustee in bankruptcy attempted to avoid a security interest in a patent on the basis that it was not recorded in the Patent and Trademark Office pursuant to 35 U.S.C. § 261. Rejecting this claim, the bankruptcy court held that although a bona fide purchaser holding a duly-recorded conveyance of the ownership right in a patent, or a mortgagee who has recorded its interest as a transfer of title with the Patent Office, will defeat the interests of a secured creditor of the grantor or mortgagor who has not filed notice of its security interest in the Patent Office, the trustee will not.

The trustee is in the position of a hypothetical lien creditor [11 U.S.C. § 544(a)(1)], not a bona fide purchaser. As such, his dispute with Mitsui can be governed by the Uniform Commercial Code provisions regulating competing lien claims against the patent without conflicting with the Patent Act's provisions protecting bona fide purchasers of the patent.

48 B.R. at 635. Subsequent cases facing the same issue have followed Transportation Design. See In re Cybernetic Svcs., Inc., 239 B.R. 517 (B.A.P. 9th Cir. 1999) (recordation in the Patent and Trademark Office was unnecessary to perfect security interest in patent as against the trustee in bankruptcy); City Bank & Trust Co. v. Otto Fabric, Inc., 83 B.R. 780 (D. Kan. 1988) (same). Under Transportation Design, City Bank, and Cybernetic, a judicial lien creditor does not appear to fall within the protection of section 261 of the Patent Act, and the trustee or debtor in possession, as a

hypothetical judicial lien creditor under section 544(a)(1), would not have standing to avoid an unrecorded exclusive patent license.

B. The Effect Of Bankruptcy Where The Debtor Is The Licensee.

1. The Risk Of The Debtor's Continued Use Of The License Without Payment—In re DAK Industries.

Where the debtor is the licensee of intellectual property, the nondebtor licensor faces the risk that the debtor will continue to utilize the license after the bankruptcy filing without paying for such use as an expense of administration. In Microsoft Corp. v. DAK Indus., Inc. (In re DAK Indus., Inc.), 66 F.3d 1091 (9th Cir. 1995), the Ninth Circuit held that even where a licensee of intellectual property who filed a bankruptcy case continued to use the license after the bankruptcy filing, fixed installment payments under the license agreement that came due after the commencement of the licensee's bankruptcy case were not entitled to priority as administrative expenses, and would instead be treated as nonpriority general unsecured claims. Moreover, the debtor/licensee was not otherwise required to pay any administrative expense for its post-bankruptcy use of the license.

Prior to the commencement of its chapter 11 case, the debtor (DAK) and Microsoft entered into a "License Agreement" granting DAK certain nonexclusive, worldwide "license rights" for one year to Microsoft's Word for Windows software. Under the agreement, Microsoft would furnish DAK with a master disk containing Word, and DAK would copy the program and install Word in computers that DAK sold to end consumers. DAK agreed to pay a "royalty rate" of \$45 per copy of Word it distributed. What was critical to the Court's decision, however, was that DAK also was obligated to pay a "minimum commitment" of \$2.75 million in five installments, commencing on the date DAK sold its first copy of Word, no matter how many copies of Word it sold. The royalty rate would apply only when the minimum commitment was surpassed with the sale of approximately 61,000 units.

DAK filed its chapter 11 case after it began distributing Word, but before it had paid the last two installments under the License Agreement. During the next eleven months, DAK distributed at least 7,600 copies of Word without paying anything at all to Microsoft. During this period, Microsoft (belatedly) sought to force DAK to assume the

License Agreement. DAK succeeded in delaying any decision on assumption or rejection until the license expired by its own terms, at which time DAK rejected the license and contended that the unpaid installments were nothing more than prepetition, unsecured claims. Microsoft, in turn, sought payment of over \$340,000 in administrative expenses based upon DAK's postpetition use of its software (7,600 units @ \$45 per unit). The Bankruptcy Court denied Microsoft's request in its entirety, and the Ninth Circuit affirmed. Thus, DAK was not required to make any administrative payments to Microsoft, even though DAK made significant use of the software license following the chapter 11 filing.

The Ninth Circuit reasoned that although the agreement was only for a fixed period of time and the parties referred to the agreement as a "license," the agreement was in fact "more akin to a sale of an intellectual property than to a lease for the use of that property." DAK Indus., 66 F.3d at 1095-96. The Court relied principally upon the facts that (i) the installments constituted an absolute commitment to pay and did not necessarily have a relation to the amount of software actually sold; (ii) the installment payment dates also had no direct relationship to sales; and (iii) Microsoft provided DAK with no material services after the petition date. Perhaps most significant, however, was that the Court recharacterized the license as a "sale," because "DAK did not employ Word over a period of time in order to run its operation. Rather, it sold the program to consumers." Id. at 1096. While the Court hedged at the end of its opinion by noting that Microsoft had received substantial, prepetition payments on its minimum commitment, it is unclear what effect this mitigating fact had on the outcome of the case.

DAK Indus. may have significant implications not only for software licensors, but also for copyright license agreements under which distributors are given the right to sublicense or sell directly videos, theater or television rights, or other exploitations of intellectual property. For example, the outcome in DAK Indus. arguably would have been the same if the subject intellectual property was a film, the licensee was a distributor of home videos, and the license agreement included a minimum commitment payable in installments.

2. The Assignability Of Nonexclusive Patent And Copyright Licenses In A Bankruptcy Case.

Nonexclusive patent licenses are executory contracts that generally may be assumed or rejected, because each party to the contracts owes material continuing performance to the other. See In re CFLC, Inc., 89 F.3d 673,677 (9th Cir. 1996); In re Patient Educ. Media, Inc., 210 B.R. 237, 241 (Bankr. S.D.N.Y. 1997). Nevertheless, a debtor may not assign a nonexclusive patent license to a third party, absent consent of the licensor, because federal patent law precludes the holder of a nonexclusive license from assigning it. CFLC, 89 F.3d at 679; see also Commissioner v. Sunnen, 333 U.S. 591, 609, 68 S.Ct. 715, 724-35 (1948).

In CFLC, the debtor-licensee moved to assume a nonexclusive patent license and assign it to a buyer unrelated to the debtor. The patent licensor objected on the basis that section 365(c) of the Code prevented the assignment, because applicable federal common law precludes the assignment of nonexclusive patent licenses. The Ninth Circuit agreed with the licensor that federal patent law was "applicable law" under section 365(c) and that under federal patent law, nonexclusive licensees may not assign patent licenses without the licensor's consent. CFLC, 89 F.3d at 679.² Similar principles appear to apply in the case of nonexclusive copyright licenses. See Patient Educ. Media, 210 B.R. at 242-43 (following CFLC's rule for nonexclusive copyright licenses).

3. The Split of Authority Regarding Whether A Nonexclusive Patent License May Even Be Assumed By The Debtor In Possession.

In addition to the proscription on a debtor-licensee's ability to assign a nonexclusive patent license, the debtor licensee now faces the threat of the loss of its patent license altogether in light of the Ninth Circuit Court of Appeals' recent decision in In re Catapult Entertainment, Inc., 165 F.3d 747 (9th Cir. 1999).

² "Allowing free assignability-or, more accurately, allowing states to allow free assignability-of nonexclusive patent licenses would undermine the reward that encourages invention because a party seeking to use a patented invention could either seek a license from the patent holder or seek an assignment of an existing patent license from a licensee." CFLC, 89 F.3d at 679.

In Catapult, the debtor in possession moved to assume two non-exclusive patent licenses over the licensor's objections. In determining whether the debtor in possession could assume the nonexclusive patent licenses, the Ninth Circuit interpreted section 365(c)(1) of the Code as creating a "hypothetical test" regarding a debtor in possession's ability to assume an executory contract and found that, if, under applicable law, a debtor is not allowed to assign an executory contract to a third party without the nondebtor party's consent, then the debtor in possession cannot assume the contract even though the debtor in possession may have no intention of assigning it to a third party. Id. at 750. Relying on its earlier decision in CFLC, the Ninth Circuit stated that federal patent law constituted applicable law under which nonexclusive patent licenses are "personal and assignable only with the consent of the licensor." Id. (quoting CFLC, 89 F.3d at 680). Thus under Catapult, a debtor in possession's inability to assign a nonexclusive patent license precludes that debtor in possession from assuming the license as well. See also In re Access Beyond Technologies, Inc., 237 B.R. 32, 48-49 (Bankr. D. Del. 1999) (debtor in possession may not assume or assign non-exclusive patent license without licensor consent)

This "hypothetical test" governing the assumption of executory contracts has been adopted by other Circuit Courts. See e.g. In re James Cable Partners, 27 F.3d 534, 537 (11th Cir. 1994); In re West Elec., Inc., 852 F.2d 79, 83 (3d Cir. 1988).

The Catapult decision, however, is not the law of the land. The First Circuit Court of Appeals has held that a debtor in possession may assume a nonexclusive patent license agreement and transfer its stock to another entity without the consent of the licensor. See Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 493 (1st Cir.), cert. denied, 117 S.Ct. 2511 (1997). In Institut Pasteur, the debtor in possession moved to assume a patent license agreement and sought to confirm a plan transferring the debtor's stock to a subsidiary of a direct competitor of the licensor. The licensor objected to the stock transfer because it would cause a "de facto" assignment of the license to a direct competitor. Institut Pasteur, 104 F.3d at 490-91. The First Circuit rejected this argument and allowed the debtor in possession to assume the license agreement and transfer its stock, reasoning that the fact that federal common law prohibits the assignment of patent licenses to strangers does not preclude a debtor

in possession from assuming a patent license agreement and transferring its stock to a third party. Id. at 493-94.

With respect to the debtor in possession's ability to assume the nonexclusive patent license, the First Circuit rejected the "hypothetical test" adopted by Catapult, in favor of an "actual test" which involves a case-by-case inquiry into whether the nondebtor party is actually being forced to accept performance from an unrelated third party.

4. Other Considerations Regarding Assumption And Assignment.

Notwithstanding cases such as CFLC and Catapult, if the nondebtor licensor does not object to the assumption and/or assignment of a patent license until after confirmation of a plan, principles of *res judicata* may bar the licensor from asserting that applicable non-bankruptcy law prohibits the debtor from assuming and/or assigning the nonexclusive patent license. See Department of Air Force v. Carolina Parachute Corp., 907 F.2d 1469, 1473 (4th Cir. 1990) (where the debtor's plan of reorganization provided for assumption and assignment of a contract to manufacture parachutes for the United States government and the United States failed to object to the plan, the United States was barred by principles of *res judicata* from terminating the contract even though the United States' characterization of the bar on assignment in the Anti-Assignment Act, 41 U.S.C. § 15, appeared to be correct).

Finally, although there appears to be no reported decision in a bankruptcy context, licensees may be able to assume and assign exclusive patent (and copyright) licenses. See Catapult, 165 F.3d at 750 n.3 ("[W]e express no opinion regarding the assignability of *exclusive* patent licenses under federal law...") (emphasis in original).

5. Radio-Spectrum Licenses From the FCC - The NextWave Case.

In Federal Communications Commission v. NextWave Personal Communications, Inc. (In re NextWave Personal Communications, Inc.), 1999 U.S. App. LEXIS 33444 (2d Cir. 1999), the United States Court of Appeals for the Second Circuit held that obligations to the FCC arising from the grant of a radio-spectrum license represents the FCC's method of implementing federal policy and does not represent not a mere debtor-creditor relationship. In May and June 1996, NextWave Personal

Communications, Inc. ("NextWave") submitted winning bids for sixty-three radio-spectrum licenses at the Federal Communication Commission's ("FCC") auction. Its aggregate bids totaled \$4.74 million. Under the FCC's regulations, NextWave was required to pay only 10% of its winning bid in cash, and the remaining 90% could be paid in installments over a ten-year period. NextWave made its initial 5% deposit at the 1996 auction, and it made its second 5% deposit immediately after its application for the licenses was conditionally approved in January 1997. NextWave's application was not finally approved, however, until February 1997, by which time the market value of the licenses had fallen to less than a quarter of the amount that NextWave had bid for them. After numerous unsuccessful appeals to the FCC regarding its bid price, in May 1998 NextWave filed for protection under chapter 11 of the Bankruptcy Code. NextWave then sought to avoid the bulk of its obligations to the FCC on the grounds that the transaction in which it acquired the licenses was a fraudulent conveyance. Id. at 1-10.

The resolution of the fraudulent transfer action turned on the transfer date: the auction date on which the licenses were conditionally granted, as the FCC contended, or the date on which they were finally granted, as NextWave contended. The appellate court, deferring to the FCC's interpretations of its own rules, held that the transfer date was the auction date. Therefore, NextWave could not avoid its bid obligations as a fraudulent transfer. Id. at 32-36. In so holding, the Second Circuit noted that the FCC was not a mere creditor who had sold a property right to the debtor on credit. Rather, the FCC, in granting the radio-spectrum license, was implementing a federal policy regarding the appropriate allocation of the radio spectrum. Id. at 30-31.

III. THE EFFECT OF BANKRUPTCY ON SECURITY INTERESTS IN COPYRIGHTS, PATENTS, AND TRADEMARKS.

A creditor who takes a security interest in personal property typically will file a Uniform Commercial Code financing statement under applicable state law in order to perfect its security interest. Federal law, however, establishes special recording requirements for certain transfers of copyrights, patents, and trademarks. To the extent that any of these federal recording requirements applies to a security interest in intellectual property, a U.C.C. filing alone may not perfect that security interest and may leave it vulnerable to a challenge by a trustee or debtor in possession exercising its

avoiding powers under section 544 of the Bankruptcy Code. The issues that will arise in a bankruptcy case where a creditor who claims a security interest in intellectual property fails to record it in the Copyright Office or in the Patent and Trademark Office may include (i) whether the applicable federal recording statute applies to a security interest; and (ii) whether the parties who take priority over the unrecorded security interest include a judicial lien creditor.

A. Copyrights.

As indicated in section II.A.3.a, supra, the few reported cases addressing the issue have generally held that a security interest in a copyright is a "transfer of copyright ownership" for purposes of the recording provisions of the Copyright Act, and that the failure to record a security interest in a copyright with the United States Copyright Office in accordance with 17 U.S.C. § 205 will render the security interest avoidable by a trustee or debtor in possession, even if the secured creditor filed a financing statement under Article 9 of the U.C.C. Peregrine, 116 B.R. at 201-02; Avalon Software, 209 B.R. at 521; See also Official Unsecured Creditors' Comm. v. Zenith Prod. Ltd. (In re AEG Acquisition Corp.), 127 B.R. 34 (Bankr. C.D. Cal. 1991) (perfection of security interest in foreign motion picture requires filing in Copyright Office).

The requirement that a security interest in a copyright be recorded in the Copyright Office may be a difficult one for the lender to satisfy, because such recordation is not possible unless the copyright has been registered with the Copyright Office. See 17 U.S.C. § 205(c); Peregrine, 116 B.R. at 200 n.7; Avalon Software, 209 B.R. at 521. In Avalon Software, the Bankruptcy Court held that the lender's security interest in the debtor's copyrighted software was avoidable, because the lender had not perfected its security interests by recording a notice of transfer of copyright ownership with the Copyright Office. Avalon Software, 209 B.R. at 522. In response, the lender argued that it was unable to file a notice because the debtor had not registered the copyrighted software. The Bankruptcy Court concluded that the burden lay on lenders to ensure that debtors register any and all copyrighted property (including derivative works) in which such lenders seek a security interest. Id.

Under Avalon Software, it appears that a lender must actively monitor the copyright registration activities of its borrower to ensure that all intellectual property that might conceivably fall within the scope of the copyright laws is registered, so that an appropriate notice can be filed with the Copyright Office.³ Otherwise, the lender may risk having its security interest avoided by a trustee or debtor in possession in the event of a subsequent bankruptcy. Meanwhile, borrowers, particularly in the computer industry, may be faced with the unwelcome choice of registering their intellectual property with the Copyright Office, or not obtaining secured financing for fear that such registration would entail the risk of disclosing confidential code.⁴

If a security interest in a copyright is avoidable by reason of the lender's failure to record the security interest in the Copyright Office, the lender's security interest in accounts receivable generated by licensing the copyright may also be vulnerable, even if the lender filed a UCC financing statement covering the accounts receivable. In Peregrine, the Court held that, as a result of the lender's failure to record its security interest in the Copyright Office, the lender's security interest in the debtor's copyrights and in the receivables generated from licensing films in the debtor's film library to various programmers were "trumped by [the debtor's] hypothetical judicial lien," and, therefore, avoidable for the benefit of the bankruptcy estate. 116 B.R. at 207. Similarly, in Avalon Software, the bankruptcy court held that security interests in registered and unregistered copyright software programs, and all proceeds and other intellectual property derived therefrom, were unperfected in bankruptcy because of the failure to file with the Copyright Office. See Avalon Software, 209 B.R. at 523-24.

³ The court held that a "product to which a copyright attaches, such as computer software, acquires its character as 'copyrightable' when the intellectual work is created. 17 U.S.C. §§ 101, 201(a)." Avalon Software, 209 B.R. 521.

⁴ To register a computer program with the Copyright Office, the copyright owner must deposit "identifying portions of the program," generally the first and last twenty-five pages of the human readable source code. 37 C.F.R. § 202.20(c)(2)(vii); see also Fonar Corp. v. Domenick, 105 F.3d 99 (2d Cir. 1997); Data Gen. Corp. v. Grumman Sys. Support Corp., 36 F.3d 1147 (1st Cir. 1994). This disclosure might entail unacceptable business risk for the borrower who prefers to keep the source code secret from competitors.

A subsequent decision of the Ninth Circuit Court of Appeals, however, suggests that a lender who takes a security interest in accounts receivable generated from the licensing of a copyright, without taking a security interest in the copyright itself, may not need to (and, in fact, may be unable to) record the security interest in the accounts in the Copyright Office in order to perfect it. See Broadcast Music, Inc. v. Hirsch, 104 F.3d 1163, 1166-67 (9th Cir. 1997). In Broadcast Music, a songwriter to whom BMI paid royalties derived from his compositions assigned his future royalties to certain creditors to satisfy his debts to those creditors, and directed BMI to pay the royalties directly to the creditors. This assignment was not recorded in the Copyright Office. Thereafter, the IRS recorded notices of tax liens against the royalty income. The issue before the court was whether a federal tax lien took priority over a prior, unrecorded assignment of the taxpayer's right to receive royalty income from the performance of a copyrighted work.

Citing Peregrine, the IRS claimed that it was entitled to priority under the Copyright Act, because the earlier royalty assignments should have been recorded in the Copyright Office as security interests in a copyright. The Court disagreed, holding that the assignment of the royalty income was not a "transfer of copyright ownership or other document pertaining to a copyright," that was subject to the recording rules of the Copyright Act. 104 F.3d at 1166. In distinguishing Peregrine, the Ninth Circuit focused on the fact that, whereas Peregrine involved a security interest, "this is a case of outright assignments of a right to receive royalties for the purpose of satisfying a debt." 104 F.2d at 1166. A more persuasive distinction, however, might have been that, whereas Peregrine involved a transfer of the copyright itself in the form of a security interest, Broadcast Music involved neither a security interest in, nor any other transfer, of the underlying copyright. In any event, Broadcast Music did not discuss, let alone answer, the practical question of how one is to distinguish an "assignment" of a royalty to pay a debt from a security interest in that royalty to pay a debt.

B. Trademarks And Patents.

As with security interests in copyrights, a debtor in possession or trustee in bankruptcy may avoid a security interest in a trademark or a patent if that security interest is not properly perfected. However, the method of perfecting a security interest

in a trademark or a patent differs from that of a copyright. Case law appears to be in uniform agreement that a security interest in a trademark is properly recorded by filing a financing statement in compliance with Article 9 of the U.C.C. See In re Together Development Corp., 227 B.R. 439, 441 (Bankr. D. Mass. 1998) (a security interest in a trademark not perfected by recordation in the Patent and Trademark Office, but rather by filing a financing statement in compliance with Article 9 of the U.C.C.); 199Z, 137 B.R. at 782 (security interest in trademark perfected by filing UCC-1 Financing Statement); Roman Cleanser Co. v. National Acceptance Co. (In re Roman Cleanser Co.), 43 B.R. 940 (Bankr. E.D. Mich. 1984), aff'd mem., 802 F.2d 207 (6th Cir. 1986) (filing of an appropriate UCC-1 Financing Statement sufficient to perfect security interest in registered trademarks); Creditor's Comm. of TR-3 Indus., Inc. v. Capital Bank (In re TR-3 Indus., Inc.), 41 B.R. 128 (Bankr. C.D. Cal. 1984) (security interest in trademarks perfected by filing UCC-1 Financing Statement).

Likewise, a security interest in a patent is perfected by filing a financing statement in compliance with Article 9 of the U.C.C. For example, in In re Cybernetic Svcs., Inc., 239 B.R. 917 (B.A.P. 9th Cir. 1999), two creditors filed a motion for relief from the automatic stay in order to foreclose on their security interest in the debtor's patent. The chapter 7 trustee opposed the motion asserting that the creditors did not have a perfected security interest in the debtors' patent because the creditors did not file a financing statement with the Patent and Trademark Office pursuant to 35 U.S.C. § 261. The Bankruptcy Appellate Panel rejected the trustee's argument, determining that, unlike the Copyright Act, the Patent Act did not provide mandatory recording provisions for perfect security interests in patents that would preempt alternative state-law methods. Id. at 923. As a result, the BAP concluded that a security interest in a patent is perfected by filing a financing statement with the Secretary of State in accordance with Article 9 of the U.C.C., rather than with the Patent and Trademark Office. Id. See also City Bank, 83 B.R. at 781-84; Transportation Design, 48 B.R. at 638-39. In any event, it is questionable whether the trustee (or debtor in possession) can avoid a security interest in a patent or trademark if the only infirmity is the failure to file with the Patent and Trademark Office because the patent and trademark laws expressly protect subsequent bona fide purchasers (which the trustee in bankruptcy is not), whereas the

copyright laws also protect judicial lien creditors (which status the trustee in bankruptcy in accorded). See id.; Peregrine, 116 B.R. at 204-07.

C. Trademark/Copyright Hybrids – The Problem Of Product Labels.

As discussed in the preceding two sections, a security interest in a copyright is perfected by filing in the Copyright Office, while a security interest in a trademark or patent is perfected by filing under the Uniform Commercial Code. In many instances, however, a trademark may be inseparably intertwined with underlying copyrightable material as in the case of a consumer product label. In such a situation, a filing in the Copyright Office may be necessary to perfect a security interest in the copyrightable label. Consequently, a creditor who takes a security interest in a manufacturer's inventory without filing in the Copyright Office with respect to copyrightable labeling may end up having to deal with the inventory (and having it valued) as unlabeled product.

The copyrightable nature of product labeling is highlighted by the recent Supreme Court decision in Quality King Distribs., Inc. v. L'Anza Research Int'l, Inc., 523 U.S. 135, 118 S. Ct. 1125 (1998). There, L'Anza manufactured and sold shampoo in specially labeled bottles throughout the United States and Europe. L'Anza heavily advertised its shampoo in the United States and attempted to limit its U.S. distribution to upscale retailers. When L'Anza found out that the shampoo bottles sold in Europe were being resold in the United States at discount stores, L'Anza sued the importer, Quality King, for copyright infringement, alleging that selling the labeled shampoo bottles at discount stores damaged the value of L'Anza's upscale product. Quality King responded that it had a right to resell the shampoo under the "first sale" exception of the Copyright Act.⁵ In agreeing with Quality King that L'Anza's shampoo label fell within the "first sale" exception, the Supreme Court implicitly recognized that product labels, under

⁵ The "first sale" exception, codified in 17 U.S.C. § 109(a), permits the owner of a copy of a work lawfully acquired under the Copyright Act to resell that particular work without infringing on the copyright of the owner. Thus, Quality King argued that since it had lawfully purchased the bottles of shampoo, it could resell the bottles without infringing on L'Anza's copyright.

the proper circumstances, could be protected by copyright. Thus, the Court brought into focus the fact that many types of consumer products contain substantial amounts of copyrightable material that is integral to their value.

Quality King may prove to be a trap for an unwary creditor with a security interest in a manufacturer's inventory of labeled products. By filing under the U.C.C., a creditor could properly perfect its security interest in both the inventory and in any associated trademarks. However, the security interest would remain unperfected as to any of the product's copyrightable labeling material, unless a security interest in the copyrightable material was recorded in the Copyright Office. Thus, the secured creditor might find itself in the anomalous position of having a properly perfected security interest in the inventory and the trademark, but not in the copyrighted labeling material. As a result, the secured creditor might face a situation where: (i) it would have to remove the labeling in order to sell the inventory (thereby reducing the realizable value of the inventory from that of a branded product with consumer recognition to that of a commodity product) unless it could acquire a license from the debtor's bankruptcy estate; and (ii) the inventory held as collateral would be valued at a lower amount for purpose of valuing the secured creditor's collateral under 11 U.S.C. § 506(a), because the inventory might be valued as more of a commodity than as a branded item. To complicate matters further, the copyrightable material would have to be registered in order for the secured creditor even to be able to file a notice with the Copyright Office in order to perfect its security interest therein. See Section III.A, supra.

IV. THE EFFECT OF THE AUTOMATIC STAY ON PREPETITION PATENT INFRINGEMENT ACTIONS

Section 362(a) of the Code provides that the filing of a petition "operates as a stay, applicable to all entities, of –

The commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title...

11 U.S.C. § 362(a).

As a result, non-bankruptcy legal proceedings against the debtor are generally stayed once the debtor files its petition. A different rule, however, appears to apply where a preliminary injunction is issued against the debtor in a prepetition patent infringement action.

In Seiko Epson Corp. v. Nu-Kote Int'l, Inc., 190 F.3d 1360 (Fed. Cir. 1999), for example, the United States Court of Appeals for the Federal Circuit held that, although a patent infringement action against the debtor was stayed under the Bankruptcy Code, the preliminary injunction order entered in that action before the debtor commenced its bankruptcy case remained in effect. The patent infringement action arose when Seiko Epson Corporation and Epson America, Inc. (collectively, "Epson") brought a federal action against Nu-Kote International ("Nu-Kote") and its manufacturing affiliate, Pelikan Produktions A.G. ("Pelikan"), for patent and trademark infringement relating to Nu-Kote's manufacture of ink cartridges. The district court issued a preliminary injunction against Nu-Kote and Pelikan based on the patent infringement issue. Id. at 1362. Epson subsequently charged Nu-Kote and Pelikan with violating the preliminary injunction. After hearings, the district court issued various orders holding the defendants in contempt. Nu-Kote and Pelikan cross-appealed the order issuing the injunction and the finding of contempt.

Subsequently, Nu-Kote (but not Pelikan) filed a voluntary petition under chapter 11 of the Bankruptcy Code. Nu-Kote then filed a motion before the Bankruptcy Court arguing that the Bankruptcy Code's automatic stay prohibited further action on the appeal with regard to either Nu-Kote or Pelikan. Id. The Federal Circuit held that the automatic stay triggered by Nu-Kote's petition did not preclude the effect of the district court's previously issued orders enjoining the further infringement on Epson's patent:

[T]he statutory stay of proceedings as to Nu-Kote did not free Nu-Kote of the contempt orders and the injunctions upon which the contempt was based, all of which were entered before Nu-Kote suggested bankruptcy. . . . [Therefore,] the previously issued injunction against further infringement remains in effect during Nu-Kote's bankruptcy.

Id. at 1364-65 (citing In re Chateaugay Corp., 944 F.2d 997, 1008 (2d Cir. 1991) (injunction prohibiting future pollution survives bankruptcy)); In re Cinnabar 2000 Haircutters, Inc., 20 B.R. 575, 577 (Bankr. S.D.N.Y. 1982) ("the bankruptcy laws should

not be a haven for contumacious conduct in violation of a party's judicially-determined tradename rights which will be diluted by a continuation of such conduct behind the shield of the automatic stay"). The appellate court went on to note that Nu-Kote's bankruptcy would not protect it from liability for ongoing violations of the injunction. Seiko Epson Corp., 190 F.3d at 1365.